ADPIA

Australian **Direct Property Investment** Association

Our Ref: JC:RB:ADPIA

The Secretary
Review of Business Taxation
Department of the Treasury
Parkes Place
CANBERRA ACT 2600

27 April 1999

Dear Sir / Madam

ADPIA Submission on "Review of Business Taxation - A Platform for Consultation (Discussion Paper 2)"

The Australian Direct Property Investment Association ("ADPIA") has pleasure in presenting its submission in response to the second discussion paper - **A Platform for Consultation**.

ADPIA supports the overall objectives of the Reform process. However, it views with deep concern the proposal to tax investment vehicles such as property trusts (which include property syndicates, direct property investment vehicles and joint acquisitions) as companies. This will significantly disadvantage medium to low income investors (including retirees) who derive substantial non-tax benefits from the industry's product offerings and as a consequence, will adversely affect the dynamic and rapidly growing direct property investment industry.

About ADPIA

ADPIA was formed in December 1998 to represent organisations which offer direct property investments to the public and to institutions. ADPIA's members include organisations such as Property Syndicators, Joint Acquirers, Macquarie 'Direct', etc. which we refer to as "Originators" (and "Advisors" comprising lawyers, accountants and property consultants who advise the Originators).

The industry has grown massively in the past few years with over $3 billion worth of properties under management throughout Australia and with more than 10,000 investors. The main catalyst for the industry's growth is that it offers investors part ownership of professionally managed properties which mirror the performance and returns of direct property rather than the stock market. These properties, typically, are too expensive for investors to acquire individually but for the economies of scale inherent to these collective investments.

An example illustrating the phenomenal rise of this industry is that of MCS Property Limited, of which I am the Managing Director. Over the past five years, MCS has grown to the point where it is now amongst the Top 10 Australian Shopping Centre Owners, ahead of Centro Properties Limited, Stockland Trust Group and Colonial Limited, and manages 21 shopping centres totalling over 250,000 m^2 of retail area.

ADPIA aims include -

- Leadership in the direct property investment (DPI) arena.
- Representing the interests of members to the government, media and public.
- Providing education to members and the public.
- Building consumer awareness and confidence of DPI products.
- Assisting professional growth of its members.
- Producing and distributing relevant research material to members.
- Promoting integrity and Best Practice standards amongst the industry.

Should you have any queries or require further information, please don't hesitate to contact the writer. In addition, further contacts are listed on the final page of the submission.

Yours faithfully
Australian *Direct Property Investment* Association

Julius Colman
President

Encl.

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ADPIA

Australian **Direct Property Investment** Association

Review of Business Taxation
'A Platform for Consultation'

Response to
Discussion Paper 2 -
Building on a Strong Foundation

Taxing Property Trusts and Direct Property Ownership Vehicles as Companies is not in Australia's interest

Submission by the

Australian
Direct Property Investment
Association

15 April 1999

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1. Executive Summary

1.1. The Australian Direct Property Investment Association ("ADPIA") represents organisations that offer direct property investments or "DPIs" (including property syndications and joint acquisitions) to the public and to institutions. DPIs offered by ADPIA members typically use trusts structures to hold the properties on behalf of the investors, although partnership-type structures are also used (joint acquisitions).

1.2. DPIs are one of the only options available which give low and middle income investors (including pensioners) the opportunity of owning a direct interest in quality commercial properties that exhibit true property performance.

1.3. ADPIA supports the Government's intention to tax certain trusts as companies *where those trusts carry on an active business*. However, where trusts are no more than a *bare trust* or unit trust that acts as a conduit which enable investors to pool their resources to make a productive investment in a managed fund such as property, then APDIA submits that these trusts should continue to allow a "flow through" of income so that the income is taxed in the hands of the beneficiaries.

1.4. ADPIA understands that the whole desire to tax trusts was driven out of the desire to attack the revenue loss and timing delays caused by discretionary trusts and the obvious desire to make a choice of vehicle not tax dependent. Perhaps the agenda has become mis-focused and started to settle on unit trusts whereas the correct target is really the discretion to re-route earnings.

1.5. This submission is a response to *A Platform for Consultation* and deals specifically with the issue of taxation of the trust structures outlined above (and detailed further).

1.6. True property performance is significant because direct property is a separate asset class which moves in different cycles to other asset classes such as shares, cash or bonds. Although small to medium income investors have the opportunity of investing in Listed Property Trusts ("LPTs"), these vehicles exhibit behaviour akin to stocks and so are exposed to stock market volatility. LPTs are an entirely different asset class to DPIs and this factor is becoming increasingly important as stockmarkets approach record highs with a corresponding increased potential for volatility.

1.7. ADPIA opposes the concept of taxing certain trusts as companies for the following reasons:

1.7.1. Most investors in DPIs are middle to low income earners (including pensioners) and would suffer substantially.

- Taxing trusts would reduce cash yields by up to 50% and will especially hurt small investors who may have to wait up to 9 months to receive an imputation refund without interest.
- Many existing investors would suffer significant financial stress because they have entered into financial arrangements reliant upon receiving the originally forecast prospectus yield.
- Smaller investors would be discriminated against by being denied the tax benefits available to wealthier investors who are able to purchase these properties outright or in a partnership type structure.
- Investors would lose the benefit of management expertise offered by managers of DPIs.

1.7.2. There will be a depletion of savings due to investors being deterred by the reduced attractiveness of investing in trusts.

1.7.3. Trusts are fundamentally different to companies because they are required to distribute 100% of their taxable income and they perform a specific role in investment markets as a passive pooling mechanism for small investors.

1.7.4. Most of the world's leading economies only tax public unit trusts in the hands of investors. Taxing trusts as companies will disadvantage international investors and place Australia at a disadvantage when competing for international investment funds. Many investors in DPIs are from outside Australia.

1.7.5. Trusts do not provide a mechanism for tax leakage.

1.7.6. Investors' motives when investing in DPIs are not based on tax avoidance or 'tax mischief'.

1.7.7. The new and massively growing DPI industry, with assets of more than $3 billion under management and which offers so much in terms of new employment and leadership in financial products, would be very seriously affected and would see the stunting of what could be a major plank in the Government policy to promote Australia as a global financial centre.

1.7.8. Taxing trusts as companies will introduce significant compliance costs to change administration systems to accommodate the proposed tax regime.

1.7.9. As a result of the above, investors may revert to investing in residential properties and this may not be viewed as advancing the Australian economy or the Australian industry generally.

1.8. ADPIA submits that the definition of a Collective Investment Vehicle ("CIV"), which will allow "flow through" taxation, should include the investment products that APDIA members offer, i.e. direct property investments ("DPIs"), property syndications and joint acquisitions.

1.8.1. ADPIA would like it to be clear that DPIs are not "active businesses" (or "trading trusts") because the individual investor's investment is genuinely passive even though the investment is managed by a professional manager.

1.8.2. ADPIA questions why a trust used as a conduit for a passive investment, which is managed by a professional manager, should be treated differently just because it has, for example, less than 50 investors. All CIVs that are not trading trusts within the current definition in Section 102N of the Income Tax Assessment Act 1936 ("the Act") should be allowed flow through status.

1.8.3. The key principles of a tax system are equity and efficiency. The proposal to tax passive investment trusts as companies is inequitable as the investment should be seen as no different to a direct investment.

1.8.4. ADPIA submits that there is no "competitive advantage" of trusts over companies in respect of DPIs. ADPIA further submits that it would be inequitable on the basis of competitive neutrality to treat property trusts differently to direct investment by individuals in property.

1.8.5. ADPIA supports the Treasurer's announcement that property trusts should be included in the definition of a CIV.

1.8.6. The Ralph Report proposes two ways of taxing income from CIVs. ADPIA submits that a property trust is a CIV and the first option is its preferred option. The two options are:

- Not taxing tax preferred income. This is ADPIA's preferred option of the two. However it is clear from the Ralph Report that this is currently not favoured due to perceived revenue and competitive neutrality concerns. Under this option, there is some concern that property trusts would be excluded from the definition of a CIV due to property trusts' perceived "active" nature. We disagree with this view and detail our reasoning in 2.4 of our submission. In addition, due to recent amendments to the tax law, there would be no revenue cost as tax deferred income (both for depreciation and building allowances) reduces the cost base of units in the trust.
- Taxing tax preferred income. This option seems to be supported by the Ralph Report. Tax preferred income distributed by a CIV would be taxed in the same way as entity distributions, i.e. as a dividend. This would have a similar effect to taxing trusts as companies leading to the detrimental results as outlined in paragraphs 1.7 and 2.3 of this submission. This option cuts across the desire to make the CIV regime equivalent to direct investment in assets and also adds complexity to the distribution process.

1.8.7. If the definition of "widely held" CIV is regarded as necessary for a CIV to have "flow through" status then ADPIA seeks clarification regarding the definition of "widely held" especially in relation to whether the definition will look through to underlying beneficial interests.

2. Contents

2.1 The Australian Direct Property Investment Association ("ADPIA")

ADPIA represents a fast growing industry comprising organisations which offer direct property investments (also known as *property syndications* and *joint acquisitions*) to the public and to institutions.

2.2 Direct Property Investment

The direct property investment industry has grown significantly in the past few years with over $3 billion worth of properties under management throughout Australia and with more than 10,000 investors (primarily middle-income earners). The main catalyst for the industry's success is that it provides investments in a structure which delivers professionally managed properties such as shopping centres and office buildings and which also delivers the performance and returns of direct property. Often these properties with their inherent benefits would only be available to wealthy investors but the economies of scale in these collective investments have allowed middle to low income earners to share in their benefits.
Most investors in ADPIA members' offerings are low to middle income earners. According to research conducted by ADPIA:-

- **56%** of investors invested $20,000 or less;
- **32%** invested between $20,001 and $50,000;
- **8%** invested between $50,001 and $100,000; and
- only **3%** invested more than $100,000.

2.2.1 The Structure of DPIs

The basic principle behind a DPI is that owners pool their resources to purchase a property (or properties) and then pay a Manager to manage the assets.
Typically, ADPIA members structure their offerings in two ways: as partnerships or trust vehicles, where a custodian or trustee holds the property or properties on behalf of the Owners. The Owners can be partners, tenants in common, or trust beneficiaries. The Owners then pay a Manager, who is often the Responsible Entity, to manage the property. The property is purchased with Owners' subscriptions and loans to the Owners secured by a mortgage over the property. The loans are typically limited-recourse to the Owners with the lender having access to the property, assets and income in the vehicle but not able to go behind the vehicle to the assets of the investor.
The Managed Investments Act 1998 ("MIA") has altered some elements of the structure and imposed several additional obligations, the primary objectives being investor protection. Importantly, the MIA doesn't alter the basic premise that benefits pass through to the investor, but in fact improves the security of the income to the investor because the single responsible entity is bound, inter alia, to distribute all taxable income.
Figure 1 below graphically shows a typical structure.

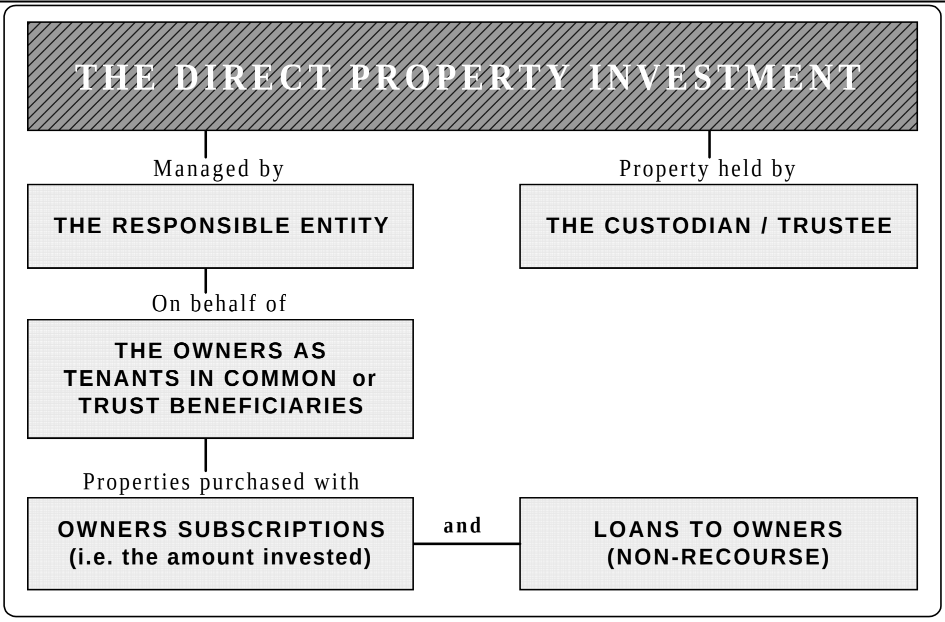

Figure 1 - Typical Structure of a Direct Property Investment

2.2.2 Characteristics of DPIs

DPIs are investments in direct property and typically contain the following key characteristics:

- investors who subscribe pursuant to a prospectus invest only in the property or properties described in that prospectus. The Manager has no power to add any other property to that investment;
- The vehicle has a finite life - or in other words a finite date at which the Manager must sell the property/ies in the vehicle or at which investors have the opportunity to exit the vehicle at the underlying net value of the property assets. (The underlying NTA can be determined by obtaining an independent valuation). There are some limited circumstances where the vehicle's life can be extended.
- immediately the property or properties are sold, investors are paid the net proceeds of sale;
- if there are no remaining properties in the vehicle, the vehicle is at an end;
- Investors' liability is limited to the funds subscribed.

The first four elements above differentiate DPIs to LPTs. In an LPT, an investor can almost never access the underlying NTA. If the underlying NTA cannot be accessed by an investor, then the asset will not perform in accordance with its underlying value but rather in accordance with an assessment of future cash flows. DPIs provide direct property performance because the properties are identified and there is a fixed time in the near future when access to the underlying NTA is provided to the investor.

2.2.3 The role of Direct Property Investment in reducing risk through diversification

In order to reduce their overall risk, prudent investors will seek to diversify their assets amongst the major asset classes, cash, bonds, shares and property.

Diversification is increasingly important in today's investment environment with record low interest rates coupled with record stockmarket levels and high volatility. Low interest rates have deterred many investors from cash and bonds focussing interest in shares and property.

Diversification is a key factor in portfolio theory. True diversification entails that there should be a spread of investments amongst the different asset classes, and particularly into asset classes that move in different directions.

Direct property is the only major asset class which moves in different cycles to shares. Figure 2 shows the performance of direct property compared to shares (All Ordinaries index) over the last 13 years. The graph clearly shows that there is no correlation between shares and direct property.

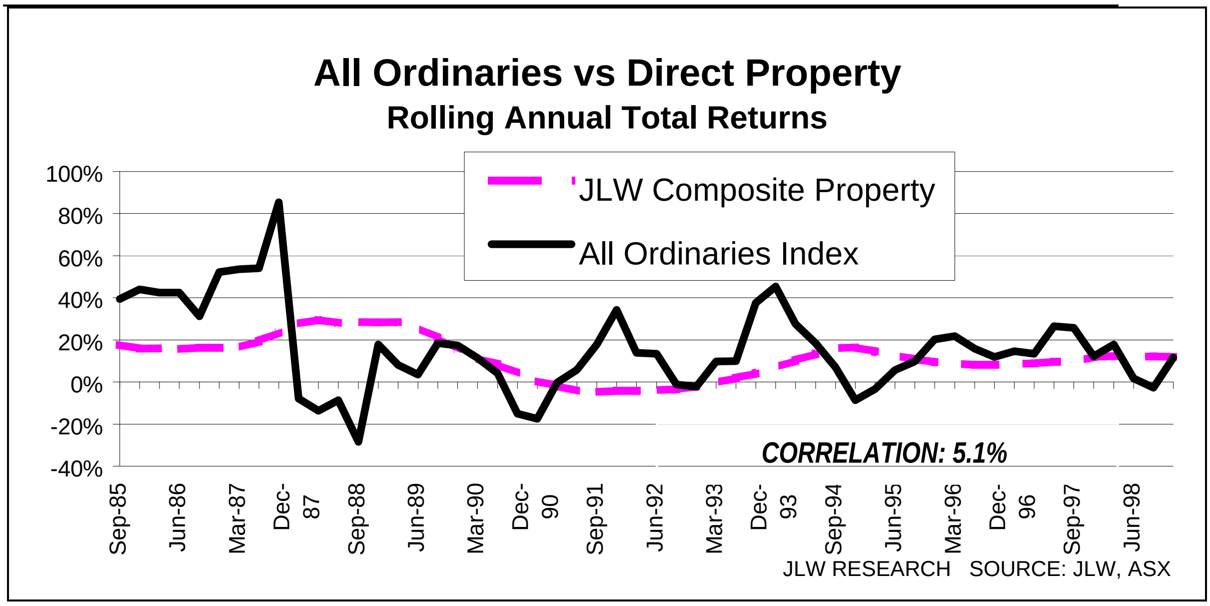

Figure 2

Figure 3 below compares direct property with LPTs and shows a negative correlation between these two asset groups. Clearly, LPTs exhibit the behaviour of shares and therefore do not deliver the diversification benefit that investment in different asset classes seeks. (ADPIA is not arguing the merits of DPIs over LPTs, it is merely saying that they are manifestly different asset classes).

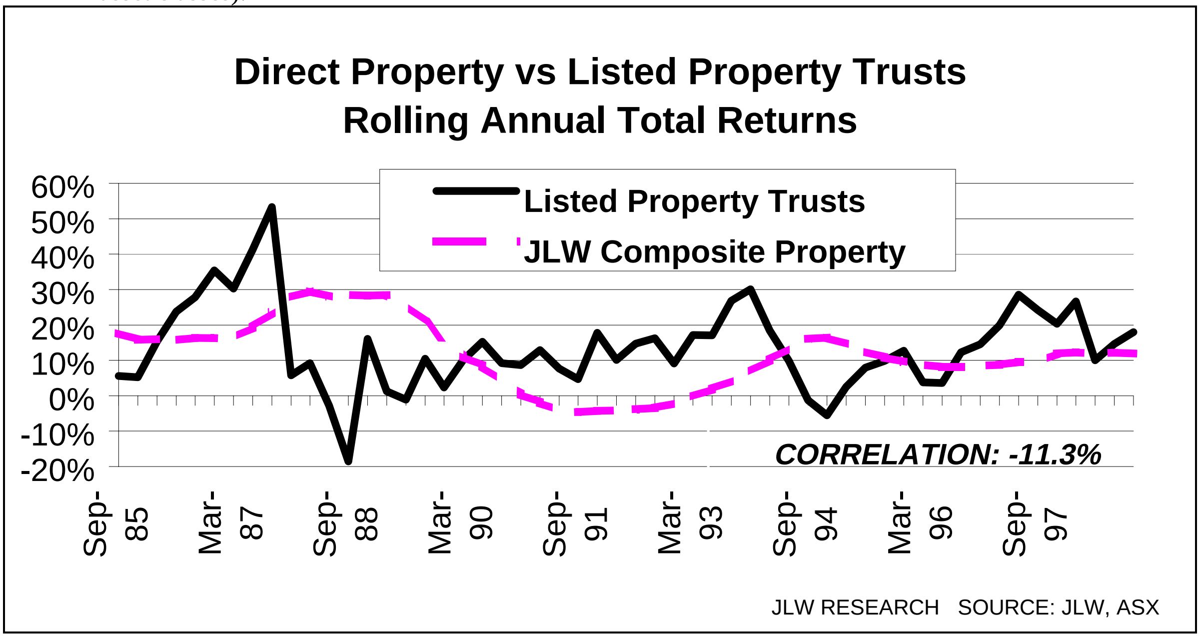

Figure 3

Figure 4 below compares all three indices: The All Ordinaries, the Property Trust Index and the JLW Composite Property Index.

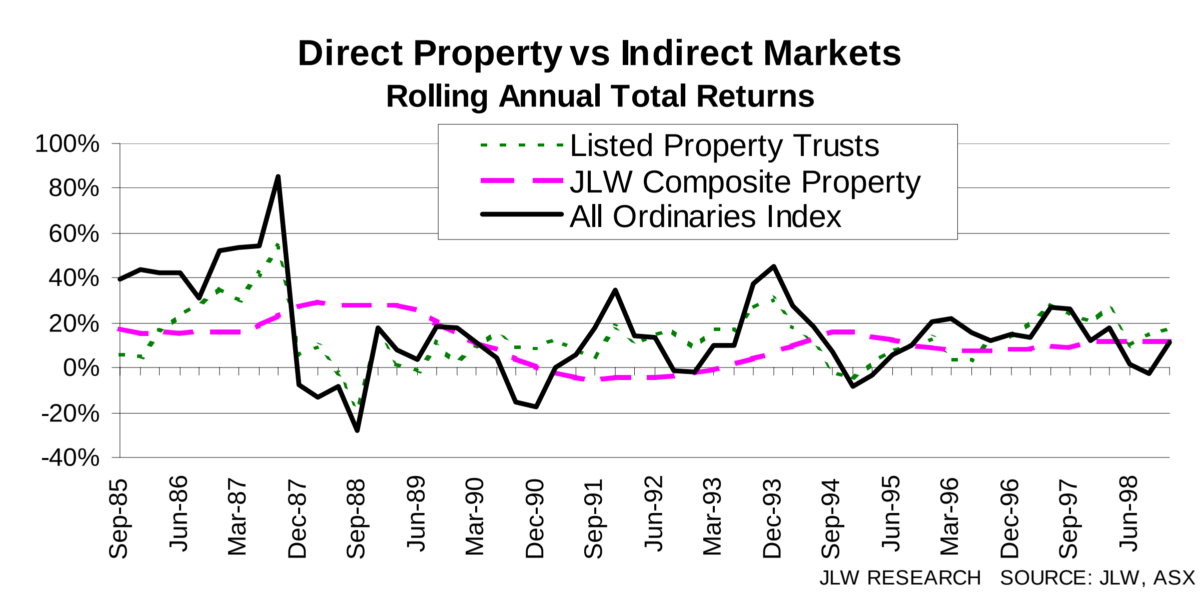

Figure 4

The graphs above clearly show that direct property is a different asset class to shares (including LPTs). ADPIA submits that DPIs are a very important investment vehicle in an investor's portfolio as they provide true property performance and are one of the very few ways that most people can gain the diversification benefits that direct property ownership brings. There are very few people who can afford to buy quality property themselves.

2.3 Taxation of Trusts as Companies

ADPIA supports the Government's intention to tax certain trusts as companies where those trusts *carry on an active business*. However, where trusts are no more than a bare trust or conduit which enable investors to pool their resources to make a productive investment in a managed fund such as property, then APDIA submits that these trusts should continue to allow a "flow through" of income so that the benefits are taxed in the hands of the beneficiaries. ADPIA understands that the whole desire to tax trusts was driven out of the desire to attack the revenue loss and timing delays caused by discretionary trusts and the obvious desire to make a choice of vehicle not tax dependent. Perhaps the agenda has become mis-focused and started to settle on unit trusts whereas the correct target is really the discretion to re-route earnings.
In addition, ADPIA submits that this flow through status should be allowed to all managed investment schemes and to managed investment schemes in which the only investors are registered managed investment schemes or complying regulated superannuation funds.
If these types of trusts are taxed as companies, the following adverse consequences would occur:

2.3.1 Disadvantage to low and middle income investors

As mentioned previously, most investors in ADPIA members' offerings are middle to low income earners and retirees. DPIs give ordinary Australians the opportunity, previously available only to wealthy investors, to own quality commercial property which delivers true property performance. For example, in a typical investment, more than 500 investors, most investing less than $50,000, can between them buy a shopping centre for around $25m, and have it professionally managed and looked after for them.
Taxing trusts at source will reduce cash yields by up to 50% and will especially hurt small investors who may have to wait up to 9 months to receive an imputation refund without interest. Many existing investors would suffer significant financial stress because they have entered into financial arrangements reliant upon receiving the originally forecast prospectus yield. For example, many retirees who depend on retirement cashflow provided by trusts would be affected by not having the money up front. In addition, many retirees would be forced to deal with the complexities of the imputation system in order for them to receive their

benefits. Many do not have this ability and would typically be unable to afford to pay a tax agent for assistance.

Other detrimental results (tax and otherwise) to investors include:

- a loss of both capital gains tax indexation and averaging for gains earned on disposal of trust assets;
- taxing distributions which are not currently assessable; and
- large compliance costs to change the administration systems to accommodate the proposed tax regime.

The potential impact of the proposal to tax trusts as companies was highlighted in *The Australian Financial Review* on February 17 1999 (page 34) where Robert Harley noted that the Property Trust Index had fallen 6% in 30 days. Although no single factor could explain the shift, the fact that if the proposals are introduced, Robert Harley has predicted that yields on property trusts would fall from around 7.5% to 5.25% and this could mean small investors simply abandon trusts in favour of bank deposits. It was also noted in the same article that a submission made by IFSA showed that the impact of the proposed changes could result in a fall in prices of property trusts of up to 36%.

Small investors do not deserve to lose so much money or be so disadvantaged as a result of changes in legislation.

2.3.2 Investors compelled into poorer structures

ADPIA submits that if property trusts were to be taxed as companies, ADPIA members offerings may have to be restructured in a way that investors that still allows investors to retain the benefits of investing in direct property, for example, all investors become tenants in common. This raises massive practical difficulties, for example, a DPI with 1,000 investors would require that each individual have their name on the title! Further, approval and/or signatures would be required from each investor when new transactions, such as loans or leases, are entered into. This also raises an issue of potential investor liability which could also affect existing investors or deter prospective investors.

ADPIA is at a loss to understand any benefit that might be gained to the revenue or otherwise that could justify this sort of result.

2.3.3 Depletion of savings

If the attractiveness of investing in trusts is reduced, there would be a significant depletion in investors' savings. Many investors see shares as too risky, and depositing money in bank accounts as providing unacceptably low returns. These disincentives would discourage investors from saving. Investors may also revert to investing in residential properties and this may not be viewed as advancing the Australian economy or the Australian industry generally.

2.3.4 An impediment for international investors

There are a significant number of foreign investors in DPIs offered by ADPIA members. These existing foreign investors would be disadvantaged and future foreign investors would be deterred should all trusts be taxed as companies.

In their respective submissions, the PCA and IFSA point out that most international companies provide a 'flow through' form of investment where savings entities, such as mutual funds, allow income and tax benefits to flow into the hands of the investors at which point they are taxed. As IFSA notes, at least $5 trillion of the worlds $7 trillion mutual funds assets operate on a 'flow through' entity principle.

If the proposed changes to tax trusts as a company were to proceed, Australia will move away from a worldwide trend rather than foster a more internationally competitive market place. International investors will be disadvantaged by the proposed changes as, in many instances, they will be unable to utilise franking credits they receive. In turn, this will place Australia at a disadvantage when competing for international investment funds which are vital for the ongoing vitality of the Australian property market.

2.3.5 Investors' motives not based on tax avoidance or 'tax mischief'

DPIs offer tax preferred income primarily due to the ability to depreciate plant and equipment and to a lesser extent due to the ability to amortise building costs. These valid deductions would therefore only be available to wealthy investors who are able to buy the property outright. As Ken Traill states,

> "... the current system can hardly be described as tax avoidance. It is a system that has been with us for many decades and is fairly efficient, allowing tax benefits provided by the Act to pass through trust structures to the ultimate beneficiaries."
>
> (ICAA Submission, Appendix B).

2.3.6 No leakage to revenue

Public unit trusts including DPIs, property syndications and joint acquisitions do not provide a mechanism for tax leakage, as every dollar of taxable income from a public unit trust is taxed either in the hands of the beneficiaries at their marginal rates or in the hands of the trustee at the top marginal rate. The requirements of treating all unitholders equally combined with the annual distribution of all trust income, means that there is no scope for the deferral of tax on income or realised gains. Further, non-assessable distributions to unitholders are bought to tax on disposal of units in a trust.

The Ralph Committee seems to imply that there is a cost to revenue where building depreciation does not form part of the cost base adjustment for units in a unit trust. Although this may be the case, the Ralph Committee have neglected the proposals put forward in Tax Laws Amendment Bill (No.2) 1998, which recently became law effective from 13 May 1997, which requires the cost base of a building to be adjusted to claw back building depreciation on subsequent sale, where a deduction has already been claimed. Accordingly the net affect of these proposals means that there is actually no cost to revenue, other than a timing issue. This timing issue also exists with the depreciation element of non-assessable distributions but is not a new issue so that there is no cost to current revenue.

In addition, investors must supply tax file numbers ("TFN") to the Manager of a DPI or if no TFN is supplied, tax at the highest marginal rate must be withheld from distributions. Accordingly, there is no danger of tax leakage.

2.3.7 May threaten industry

ADPIA submits that the dynamic and rapidly growing DPI industry may be adversely affected because, as mentioned in paragraph 2.3.1 above, taxing trusts as companies would reduce the attractiveness of investing in trusts. Investors who currently invest via trusts would suffer a substantial tax detriment and lose the benefit of management expertise offered by managers of DPIs. In addition, large compliance costs will be incurred in the modification of administration systems to accommodate the proposed tax regime.

We are on the doorstep of a massive new financial services industry. The demand for a securitised direct property product has been shown to have almost limitless potential with investors funds attributed to this sector escalating rapidly to more than $3 billion today and potentially many times that in the next few years.

ADPIA recognises and supports the Government's policy initiatives to promote Australia as a global financial centre. Reference is made to the article in the Australian Financial Review (by Rogers & Aylmer on 13 April 1999 in page 3) where the chairman of the Financial Sector Advisory Council's Regional Financial Centre Task Force, Mr Les Hosking, said, "We want to change the mindset in Canberra away from domestic, revenue-neutral tax policy changes … to things that will make Australia globally attractive."

The Managing Director of Australia's largest producer of DPI product, Julius Colman of MCS Property Limited, estimates that the industry has the potential in the short-term to grow to more than $30 billion of property under management in Australia. "The potential for the business is greater than that", he says, " as it offers huge employment opportunities, and the ability to make Australia a focus in this part of the world for quality and creative financial products." As an example of the dynamic nature of the DPI industry, Mr Colman pointed out that MCS has been granted Federal Government approval to conduct an Exempt Stock Market in its DPIs - the first Australian property company to be granted this privilege. This market, known as "The Australian Exempt Property Market", is operated by Austock Management Limited and allows liquidity for investors of DPI product offered by MCS. "This market", says Mr Colman, " has the potential to develop into a new and separate Stock Exchange, or Property Exchange."

Owen Lennie, Managing Director of the York Capital Group Limited which is an executive member of ADPIA, said "Australia has invented and basically perfected the property trust in its current form. It is superior in structure and format to the Real Estate Investment Trust (REIT) and other similar vehicles found in the United Kingdom and the United States. The proposals to tax property trusts as companies will discriminate against small investors, hurt the industry and damage Australia's high international regard in this area."

2.3.8 Commentary

The flow through provisions should not place investors in property through a managed investment scheme at a disadvantage to direct property investors - the report contains no justification for any discrimination against this class of investor and, in particular:

- Depreciation of buildings, plant and equipment and furniture fittings and equipment is a genuine expense of investment and not "tax preferred income" and, as a legitimate allowable deduction, should not give rise to a tax liability;
- If the Government believes that allowable rates of depreciation are too high, the correct course is to reduce the allowable rates, not to try to turn a deduction into taxable income by legislative legerdemain;
- A key advantage of the current property investment vehicles is the simplicity of administration - this will be gratuitously destroyed by the proposed "flow through" arrangements, as tax returns will become more complex and time consuming for both the entity and the small investors;
- The current tax law discriminates between taxable income and allowable deductions, on the one hand, and amounts of capital, on the other, in line with generally accepted accounting principles of long standing. The proposal to introduce the alien concept of "tax preferred income" will introduce definitional and practical difficulties, increase compliance costs to investors and give rise to inadvertent non-compliance due to the complexity of the law and the departure from common sense concepts; and
- The current position where distributions of a capital nature reduce the cost base of the investors' interests in the investment vehicle is defensible on the grounds of horizontal equity, proper accounting principles and administrative simplicity and no reason for complicating the process is set out in the Report.

2.3.9 Choice of taxation status

ADPIA submits that there should be a choice for an entity to elect to be taxed as a company.

2.4 Collective Investment Vehicles

The Ralph Report has proposed that vehicles within the definition of Collective Investment Vehicles ("CIVs") will be allowed to have their income flowing through the CIV and assessed in the hands of the investors. ADPIA submits that DPIs such as those offered by its members should fall within the definition of CIVs.

ADPIA notes in the Ralph Report that CIVs have been defined as *widely held vehicles undertaking investments that are not of an active business nature and not involving control of business operations which deliver a full flow-through of annual profits to participants*.

2.4.1 DPIs are not "active businesses" or "trading trusts"

ADPIA submits that DPIs are not "active businesses" because the individual investor's investment is genuinely passive. ADPIA recognises and supports the Government's concern that certain trusts that "carry on a business" should rightfully be taxed as companies. However, investors in DPIs merely subscribe their funds and receive a return, not unlike cash management trusts, listed property trusts and the numerous other managed equity funds provided by other financial institutions. Like these vehicles, the Manager of a DPI fund applies its expertise to secure and improve returns to investors. Therefore, DPIs have similar characteristics and functions to other managed funds and it submits that it would be anomalous and inconsistent to classify DPIs as "active businesses" when clearly the investment is passive from the investor's point of view.

Indeed, current tax law supports the view that a property trust such as those used by many ADPIA members are not active businesses in the definition of trading trusts in the Act. This position that these property investment vehicles are not trading entities has also long been accepted by both the Commissioner of Taxation and the Australian Prudential Regulation Authority.

Section 102N of the Act states that a unit trust is a trading trust if the trustee carries on a trading business or is able to control (directly or indirectly) a trading business carried on by another person. Trading business is defined in Section 102N of the Act to mean a business that does not consist wholly of the eligible investment business. The definition of eligible

investment business includes investing in land for the purpose (or primarily for the purpose) of deriving rent.
Reference is made to paragraph 16.24 of the Ralph Report, and ADPIA submits there is no “competitive advantage” by trusts over companies because, to the knowledge of the writer, properties such as shopping centres or office buildings are *almost never held as a company and therefore a comparison relating to advantage cannot be made*. In addition, ADPIA submits that the question is not whether DPIs offer a competitive advantage over other entities, it is whether, by not allowing these advantages, only wealthier investors are the ones allowed to benefit from the deductions and other allowances provided by taxation law.

2.4.2 DPIs are generally “widely held”

ADPIA submits that if the trust meets the requirements as currently set out in the Act that it is not a trading trust, i.e. it is merely a conduit for a passive investment, that trust should not be taxed as the company.
For example, ADPIA questions why such a trust used as a conduit for passive investment should be treated differently just because it has, for example, less than 50 investors. It is concerned that the trust which at one point in time has more than 50 investors and suffers a minimal change in investor numbers but moves to say 49 investors is treated differently from a tax point of view when in fact this trust is no different to a trust with 51 investors or 5001 investors.
However, should it be considered that CIVs are including property trusts need to be considered “widely held”, ADPIA submits that the definition of “widely held” should be the current public unit trust definition set out in Section 102G of the Act. This definition includes listed entities, entities offered to the public or any entity with 50 or more investors.
ADPIA is concerned that the overriding “75/20” test can be unduly harsh in terms of their members, particularly if beneficial interests are not taken into account. This point was not specifically addressed in the Ralph Report. It therefore submits that the definition of “widely held” should look to underlying beneficial interests not just those with a direct interest in trusts.
Furthermore, ADPIA submits that tracing rules should be incorporated in the “widely held” definition to exclude sub-trusts from the entity taxation regime where they are “widely held” or indirectly “widely held”.

2.4.3 Tax Preferred/Advantaged Income

The Ralph Report proposes two options for dealing with tax preferred income from CIVs. ADPIA submits that a property trust is a CIV and the first option is its preferred option.

2.4.3.1 Not taxing tax preferred income

Under this option distributed tax preferred income would be non-assessable income for investors. There is some concern under this option that property trusts would be excluded from the definition of CIV due to their supposed “active” nature. In addition, the Ralph Report implies there is a cost to revenue under this option.
Currently, the cost base of units in a trust are reduced where tax preferred income which comprise depreciation allowances is distributed meaning there would be no revenue cost plus the Tax Laws Amendment Bill (No.2) 1998, which recently became law effective from 13 May 1997, requires an adjustment by way of a “claw back” to the cost base of a building where deductions have already been claimed.
Accordingly, there is no cost to the revenue in terms of not taxing tax preferred income as the tax preferred element of the trust distribution is taxed when units in the trust are sold. At worst, there is a timing issue which presently exists under current law.

2.4.3.2 Taxing tax preferred income

This option advocates tax preferred income distributed by CIVs being taxed in an equivalent manner to distributions by companies, i.e. as dividends. ADPIA submits that this option is similar to taxing trusts as companies and therefore has corresponding detrimental effects (see paragraph 2.3).
This option of taxing tax preferred income cuts across the desire to make the CIV regime equivalent to direct investment in assets. Clearly direct investment benefit from tax preferred income. In addition, it seems to make the distribution

administration for CIVs even more complex than currently is the case. The CIV, as well as making ordinary trust/flow through distributions, will also be paying a dividend equal to the tax preferred amount.

2.4.4 Flow Through of Tax Preferences

ADPIA submits that property trusts should be included in the CIV regime and distributions of tax preferred income for property trusts should continue to flow through to property trust investors. The maintenance of flow through treatment would:

- ensure competitive neutrality between individual investment in property by wealthy Australians and that of low to medium income investors in property trusts who do not have the capacity to invest in large commercial properties individually;
- be consistent with international practice and maintain the competitiveness of Australia's property trust industry;
- avert the potential adverse impact on the DPI industry and the potential decrease in value predicted to occur in the Australian property trust sector; and
- avoid the imposition of large compliance costs to change the administration systems to accommodate a change to the income tax system.

3. Conclusion

ADPIA supports the Government's intention to tax certain trusts as companies where those trusts carry on an active business. However, ADPIA urges the Government to continue with the well established principle that where trusts are no more than a bare trust or conduit which enable investors to pool their resources to make a productive investment in a managed fund, such as a DPI, then APDIA submits that these trusts should continued to allow a "flow through" of income so that the benefits are taxed in the hands of the beneficiaries.

Taxing property trusts in a similar manner to companies would have a major negative impact on the returns to investors in DPIs and on the burgeoning financial services DPI industry. Both effects would be contrary to Government policy: the former would deter many people from saving and the latter would affect Australia's potential to be a global financial centre.

Most investors in DPI products are medium to low income earners and DPIs give ordinary Australians the opportunity, previously only available to wealthy investors, to own professionally managed quality commercial property that exhibits true property performance.

4. Supporting Submissions

ADPIA endorses the following submissions in respect of their position regarding taxation of trusts which are merely passive investment vehicles such as those provided by ADPIA members:

- Property Council of Australia (PCA), Submission to the Business Tax Review, December 1998
- Property Council of Australia, Taxing Property Trusts as Companies - It will hurt the battlers, October 1998.
- Investment & Financial Services Association Ltd (IFSA), Response to 'A Strong Foundation', 22 December 1998.
- Institute of Chartered Accountants in Australia (ICAA) - Submission on 'A Strong Foundation' (especially Annexure 'B' - Taxing Trusts as Companies - Why?).
- Financial Planning Association of Australia (FPA) - Submission on 'A Strong Foundation', 15 January 1999.
- Lend Lease - Submission on 'A Strong Foundation', 17 December 1998.

5. Acknowledgments

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- Mark O'Reilly, Partner at PricewaterhouseCoopers
- Owen Lennie, Managing Director of York Capital Group
- Solomon Gerber, Barrister-at-law, Member of the Victorian and New South Wales Bars
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6. Contacts

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